



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF MULTIFAMILY HOUSING ASSISTANCE RESTRUCTURING

DATE: May 22, 2002

MEMORANDUM FOR: PAEs

OMHAR Headquarters Staff

OMHAR Production Office Staff

FROM: Barbara Chiapella, Acting Director

Office of Multifamily Housing Assistance Restructuring (OMHAR)

SUBJECT: Prepayment Penalties in M2M Debt Restructures

Summary. This memorandum provides information on HUD's existing policy on prepayment lockouts and penalties applicable to FHA insured loans. It will assist PAEs in determining reasonableness of such fees in M2M restructuring. It also clarifies that the PAE will limit the amount of owner contributions toward prepayment penalties reflected in the owner's Capital Recovery Payment to what the owner would be required to pay toward a reasonable prepayment penalty.

Loan Prepayment Penalties. Two standards have been generally accepted by HUD when reviewing prepayment penalties and lockout provisions. PAEs may accept prepayment penalties that meet either of these standards without further review:

- **Older Standard.** A 300 basis point (3.00%) prepayment penalty, declining one-eighth percent per year for 24 years. At 20 years, the remaining prepayment penalty would be 50 basis points (0.50%).
- **More Recent Standard.** Handbook 4430.1 REV-1 paragraph 1-21.B and C permits prepayment provisions in the loan documents in some instances. See the excerpted copy of this section attached to this memo.

Potential Exceptions. There may be situations in which the PAE and OMHAR staff believe a prepayment penalty in excess of both standards is still reasonable and customary. In such cases, the PAE may recommend payment of the penalty to the OMHAR Portfolio Director for approval. The inclusion of a non-conforming prepayment penalty clause in the loan and/or bond documents will not be considered evidence that HUD "approved" or "accepted" the prepayment clause at the time of closing.

Treatment of Excessive Amounts.

- That portion of prepayment penalties in excess of what the PAE determines to be reasonable must be paid 100% by the owner.
- The PAE will limit the amount of owner contributions toward prepayment penalties reflected in the owner's Capital Recovery Payment to what the owner would be required to pay toward a reasonable prepayment penalty.

Relationship between Loan and Bond Prepayment Penalties. Many projects with prepayment penalties were also bond financed. Prepayment restrictions, penalties and other related costs (associated with the bonds) are typically addressed in both the note and the bond documents. The PAE

should assure that bond documents have been submitted and reviewed as part of the M2M eligibility/bond exemption determination. PAEs should not assume that if prepayment fees in the note are the same as in the bond documents that they are acceptable. A project could be eligible for M2M but provide for payment of excessive fees in the bond documents. The PAE must determine reasonableness of all loan prepayment fees. (Note that a change in the PRA is expected to be implemented soon which will shift the responsibility for review of bond documents for the M2M eligibility/bond exemption determination from OMHAR HQ staff to PAEs.)

For Additional Information. PAEs should discuss potentially unacceptable prepayment penalties with their Relationship Managers.

Attachment

- * The following is excerpted from Handbook 4430.1 REV-1 paragraph 1-21.B, C and D (emphasis added), available thru HUDCLIPS at <http://www.hudclips.org>:

1-21 B. Prepayment Provisions. Except as specifically permitted in paragraphs 3 through 5 below, the Note must contain the following prepayment provisions:

1. Proprietary (For-Profit) Facilities.

- a. Prepayment must be permitted in whole or in part so long as 30 days advance written notice is given to the mortgagee of intent to prepay, except as provided in paragraph 5. below.
- b. Prepayments must be permitted for up to 15 percent of the original principal amount in any one calendar year without a prepayment charge. Prepayments exceeding 15 percent may be subject to a charge agreed to by the mortgagor and mortgagee and included in the mortgage.

2. Nonprofit Facilities.

- a. Upon prior consent of the Commissioner, the mortgage debt may be prepaid in full.
- b. The Commissioner may approve partial payments to reduce succeeding monthly payments over the remaining portion of the original mortgage term.
- c. The Commissioner may also approve partial prepayments made after 30 days written notice. Prepayments exceeding 15 percent of the original principal amount may be subject to a reasonable charge on such excess agreed to by the mortgagor and mortgagee and included in the mortgage.

3. State and Local Bond Financed Projects.

Subject to compliance with paragraph C. below, projects funded from tax-exempt or taxable bonds issued by State or local governmental bodies may include the following prepayment restrictions and prepayment penalty charges:

- a. Prepayment restriction period (lockout) must not exceed 10 years plus the construction period stated in the construction contract, and

- b. Prepayment penalty may be charged after expiration of the lockout stated in paragraph “a” above, provided the charge:

- 1) During the first year following the lockout does not exceed 5 percent of the original mortgage,
- 2) Declines on a straight-line basis, and
- 3) Does not exceed 1 percent at the end of the fifth year following the lockout.

4. Other Bond Obligations or GNMA Mortgage-Backed

Securities. "Other bond obligations" refers to any agreement under which the insured mortgagee has obtained the mortgage funds from third party investors and has agreed in writing to repay such investors at a stated interest rate and in accordance with a fixed repayment schedule. Mortgages funded with the proceeds of GNMA Mortgage-backed securities or "other bond obligations" may include the following prepayment restrictions and prepayment penalty charges, subject to compliance with paragraph D. below.

- a. A lockout not to exceed 10 years plus the construction period stated in the construction contract; or
- b. A penalty charge provided the charge:
 - 1) Does not exceed 3 percent at the end of the first year following the construction period stated in the construction contract,
 - 2) Declines on a straight-line basis, and
 - 3) Does not exceed one percent at the end of the 10th year following the construction period stated in the construction contract; or
- c. A combination lockout and penalty charge in which:
 - 1) The lockout period does not exceed 10 years plus the construction period stated in the construction contract, and

- 2) The prepayment penalty does not exceed 1 percent at the end of the tenth year following the construction period stated in the construction contract.

5. Other Mortgages.

- a. Do not permit any prepayment lockout provisions, except where required by HUD regulations to hold certain types of rentals available, e.g., for Section 223(f), and Section 231.
- b. Do not permit any prepayment penalties, except that a Section 241 mortgage of \$200,000 or less may include a prepayment penalty provision for any prepayment in a single calendar year that exceeds 15 percent of the original mortgage amount, where:
 - 1) Penalties do not exceed 3 percent during the first year of the mortgage term, or 10 percent where the conditions in paragraph D below are met,
 - 2) Penalties decline on a straight-line basis, and
 - 3) Penalties do not exceed 1 percent at the end of the tenth year following the construction period in the construction contract.

1-21 C. Conditions For Including Lock-outs and/or Penalties.
Require compliance with the following conditions when permitting prepayment lockouts and/or penalties under provisions of paragraph 1-21.B. above.

1. Rider to the Note. Include the following language, allowing HUD to override the prepayment lockout and/or penalty provisions in the event of a default:
"Notwithstanding any prepayment prohibition imposed and/or penalty required by this Note with respect to prepayments made prior to _____, 19 ____, enter first date on which prepayments may be made with a penalty of 1 percent or less the indebtedness may be prepaid in part or in full without the consent of the mortgagee and without prepayment penalty if HUD determines that prepayment will avoid a mortgage insurance claim

and is, therefore, in the best interest of the Federal Government."

- a. Require the rider to the Note as a condition of permitting lockouts for "State and Local Bond Financed Projects," paragraph B.3. above, and "Other Bond obligations or GNMA Mortgage-Backed Securities," paragraph B.4. above.
 - b. Require the rider to the Note as a condition of permitting prepayment penalties that initially exceed 3 percent in any project.
2. Rider to the Mortgagee's Certificate. Require the mortgagee to certify that in the event of a default during the term of the prepayment lockout and/or penalty (i.e., prior to the date on which prepayment may be made with a penalty of one percent or less), it will:
 - a. Request a 3-month extension of the deadline prescribed by 24 CFR Section 207.258 for filing a notice of its intention to file an insurance claim and its election to assign the mortgage;
 - b. Assist the mortgagor arrange refinancing to cure the default and avert an insurance claim, if HUD grants the requested (or shorter) extension of the notice filing deadline;
 - c. Report to HUD at least monthly on any progress in arranging a refinancing;
 - d. Otherwise cooperate with HUD in taking
 - e. Require any successors or assigns to certify in writing that they agree to be bound by these conditions for the remainder of the term of the prepayment lockout and/or penalty period.
 - f. Notify HUD of the delinquency where a payment is not received by the 16th day of the month in which it is due.

1-21 D. Late Charge Provisions. The mortgagee may collect a late charge for the cost of handling delinquent payments, subject to the following:

1. Charges must not exceed two cents per dollar of principal and interest in arrears more than 15 days.
2. Late charges must be separately charged to and collected from the mortgagor and cannot be deducted from any total monthly mortgage payment, or collected from any reserve escrow, residual receipts funds, or from any interest accruals thereto.